IN THE

Supreme Court of the United States

October Term, 1962

No. 80

Mark E. Schlude and Marzalie Schlude

v.

Commissioner of Internal Revenue

BRIEF FOR PETITIONERS

Robert Ash
Carl F. Bauersfeld
1921 Eye Street, N. W.
Washington 6, D. C.
Attorneys for Petitioners

Of Counsel:

Ash, Bauersfeld & Burton

Press of Byron S. Adams, Washington, D. C.

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PRIOR OPINIONS

The per curiam opinion of the Court of Appeals on remand, dated December 15, 1961, is reported at 296 F. 2d 721, and appears in the record at page 273.

The per curiam order of this Court dated June 19, 1961, granting certiorari and remanding the case, is reported in 367 U.S. 911. Rehearing was denied and the per curiam order amended at 368 U.S. 873.

The prior opinion of the Court of Appeals for the Eighth Circuit dated October 19, 1960, is reported at 283 F. 2d 234, and appears in the record at page 278.

The Findings of Fact and Opinion of the Tax Court of the United States are reported in 32 T.C. 1271 and appear in the record at pages 203-221.

JURISDICTION

The judgment of the Court of Appeals was entered December 15, 1961. (R. 274) The petition for writ of certiorari was filed March 15, 1962, and was granted May 28, 1962. The jurisdiction of this Court is invoked under 28 U.S.C.A. § 1254.

STATUTES AND REGULATIONS INVOLVED

The statutes involved are Section 22(a), 23(a)(1)(A), 41, 42 and 43 of the Internal Revenue Code of 1939; Sections 446(a), (b) and (c), 451(a) and 461(a) of the Internal Revenue Code of 1954. See Appendix, *infra*, pp. 1a-4a.

The Regulations involved are Treasury Regulations 118 (1939 Code), Sections 39.41-1, 39.41-2, 39.41-3, 39.42-1, 39.43-1 and 39.43-2; Treasury Regulations on Income Taxes (1954 Code), Sections 1.446-1(a), (b) and (c) (in part) and 1.451-1(a). See Appendix, *infra*, pp. 4a-10a.

QUESTION PRESENTED

Petitioners, as partners, operate local dance studios in Nebraska, Iowa and South Dakota. The partnership keeps its books on the accrual method of accounting. It enters into contracts for the giving of dancing lessons with students which in most instances provides that the tuition fee is payable in installments. The partnership reports as income each year that portion of the contract price which represents lessons taught or the liability under the contracts that are cancelled during the year. The Commissioner of Internal Revenue determined that the partnership must report as income the entire contract price at the time the contract is signed, regardless of whether the installment payments

were earned, received, due or payable during the taxable year. The Tax Court sustained the Commissioner and determined that the partnership had to take into income the entire contract price in the year the contract was entered into.

The question for decision is: Is income realized by the signing of an executory contract for the giving of dancing lessons, although a large portion of the amount received under the contract has not yet been earned, and another large portion of the face amount of the contract has not been received nor earned?

STATEMENT

There appears to be no dispute as to the facts and they may be summarized as follows:

Taxpayers, husband and wife, on June 18, 1946, formed a partnership known as Arthur Murray Dance Studio for the purpose of conducting and operating dance studios authorized by certain franchise agreements entered into with Arthur Murray, Inc., of New York City. The venture was carried into effect and the partnership operated studios in the States of Nebraska, Iowa and South Dakota, for the specific purpose of teaching private ballroom dancing to individual students. (R. 248-249)

There were two kinds of contracts entered into between the partnership and students desiring dancing instructions. Under one type, a portion of the total tuition was paid in cash when the contract was signed, and the balance paid subsequently in installments. Under the other, a portion of the down payment was paid in cash at the time the contract was entered into, and the balance of the down payment was to be paid in

installments, the remainder of the contract price being evidenced by a negotiable note taken from the student, payable in designated installments in accordance with the terms of the note. Under the contract the student agreed to take a designated number of hours of dancing lessons and pay therefor the amount specified as tuition. All types of contracts contained a non-cancellable provision and provided that the student should not be relieved of his obligation to pay the tuition agreed upon. The hours of lessons or instructions contracted for ranged from 5 to 1,000 or 1,200. Some of the contracts were for lifetime courses which meant that, over and above 1,200 specified hours, the student was entitled to 2 hours of lessons per month, plus two parties a year for life. By explicit terms, the studio was required to give the number of hours of instruction agreed upon. The contracts, however, did not schedule the dates when the studio was required to give and the student was to receive instructions, this detail being arranged and agreed upon from time to time as lessons were given. (R. 249-250) However, every contract specifically provided for an expiration date. (R. 146-149, Exs. 15-O to 20-T, inclusive.) Under many of the contracts, lessons extended beyond the fiscal year in which the contract had its inception. (R. 250)

Notes taken from students were transferred with full recourse to a local bank, which at the time of acquiring a note would deduct therefrom the interest charges and give approximately 50 per cent of the balance of the note to petitioners. Installment payments by students on the remainder of the note were held by the bank in a reserve account, but this reserve was not available to petitioners until the note was paid

in full by the student, after which the reserve was transferred to the partnership's general bank account. (R. 250-251)

A sizeable number of contracts was cancelled annually, the non-cancellable provision to the contrary notwithstanding. In its opinion, the Tax Court found that "cancellations were considerable in amount," noting that records of the partnership disclosed that cancellations for the respective years involved were 17 per cent, 15 per cent, and 19 per cent of sales (contracts signed) for the respective years.[1] (R. 258)

A complete double entry bookkeeping system was installed for the partnership when organized in 1946, and at the same time an accrual system of accounting was adopted with the fiscal year ending March 31. The bookkeeping system was designed and installed by a certified public accounting firm. This accounting system was used continually and consistently from the time the partnership was formed. Additionally, individual student record cards were maintained, listing all pertinent information such as name and address of student, type of contract, hours involved, total contract price, history of lessons taught, and payments made under the contract. (R. 251-252)

When a contract was entered into with a student, the "deferred income" account was credited with the total contract price. At the close of each fiscal year, the student record cards were analyzed and determination was made of the number of hours of lessons

[1] Petitioners contend that the Tax Court's percentages of cancellation are inaccurate; sales in the amount of approximately 28.4 per cent, 19.1 per cent and 25.2 per cent were cancelled in the fiscal years 1952, 1953 and 1954. (R. 191, Pet. Ex. 24)

taught which, multiplied by the rate per hour of each contract, gave the amount of income earned. The deferred income account was then reduced by that amount and an earned income account increased by the same amount. Earned income thus arrived at was reported as income on the partnership's tax return. If there was any gain resulting from the cancellation of a contract, this amount was also considered as taxable income and reported as such. (R. 252-258)[2]

The uncontradicted testimony of the accounting experts was that the system of accounting employed by taxpayers accurately reflected true income. Moreover, this uncontradicted testimony was that the method of accounting used was the only method which would do so. The Tax Court made no finding that taxpayers' system of accounting did not reflect their true income. (R. 248-257, 194-195, 231-233, 241-242)

Under the Commissioner's method of computing income, this successful and growing business would have have had an actual cash deficit of $15,259.92 at the end of the fiscal year ended March 31, 1954. As of the same date, the partnership was under the contractual obligation to teach 31,677 hours of dancing lessons. (R. 206-209, Pet. Ex. 28; R. 189-191, Pet. Ex. 24.)

The Commissioner determined that the entire amount of the contract price was income in the year in which the contract was entered into. (R. 258) Accordingly, in his notices of deficiency he increased the ordinary net income of the partnership for the fiscal years in-

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[2] Detailed schedules which correctly and precisely reflect the result of the partnership's accrual system of accounting during the years in question appear in the Findings of Fact of the Tax Court. (R. 254-256)

volved by the amounts of the increases in the "deferred income" account in those years. (R. 256) The increases in the deferred income account in the fiscal years ended March 31, 1952, 1953 and 1954 are as follows: $24,602.22 in 1952, $104,798.41 in 1953, and $12,797.97 in 1954. (R. 256) The Tax Court, three Judges dissenting, sustained the Commissioner's determination through application of the "claim of right doctrine." This means that, for income tax purposes, the full amount of the contract price had to be returned as income in the year in which the contract was entered into, irrespective of the amount of money collected and irrespective of the actual rendering of service or of any obligation on the part of the partnership to render services under the contract in years subsequent to the year in which the agreement was made. (R. 246-264) The Court of Appeals, one Judge dissenting, on October 19, 1960, reversed the Tax Court. (R. 278-291). The Court in part stated: (R. 288)

> "Even assuming arguendo that petitioners received cash payment in full at the time of contracting, the *receipt* of the funds could not be considered to be *earned* until petitioners had discharged their liabilities under the contract. Under their method of accounting, established when the partnership was formed and continually employed thereafter,[5] petitioners reported as income in their tax returns such portion of the total amount received, as under their system of accounting had

[5] This is not a situation where taxpayers are attempting to change their method of accounting. See *Brown v. Helvering*, 291 U.S. 193; *United States v. Anderson*, 269 U.S. 422; *Bacon Publishing Co. v. Commissioner of Internal Rev.*, supra, at pp. 701-702. Three qualified experts testified that the system here employed *did* reflect true income and in fact was the only method which would do so.

been earned, deferring the remainder of the amount received for inclusion in the year or years in which the remainder of their liability was discharged. Such system seems eminently designed to reflect true income."

After this Court granted the respondent's petition for certiorari, it vacated the judgment and remanded the case. Subsequently, after petition for rehearing this Court amended its order to remand so as to remand the case "for *further consideration* in light of *American Automobile Association v. United States.*" (Italics supplied) On remand, the Court below held that under the *American Automobile Association* case petitioners' method of accrual accounting "does not, for income tax purposes, clearly reflect income," and vacated its previous judgment and affirmed the decision of the Tax Court.

SUMMARY OF ARGUMENT

I

The primary requirement of the taxing statutes is that each taxpayer is required to make a return of his *true* income. Since the Revenue Act of 1916 the accrual method of accounting has been recognized as an accounting system that "clearly reflected income." In *United States v. Anderson* (1926), 269 U.S. 422, this Court explained the purpose of accrual accounting to be the matching of income with related costs in the same taxable period. Sections 41 and 42 of the Internal Revenue Code of 1939, and sections 446 and 451 of the Internal Revenue Code of 1954 are the statutory basis for using the accrual method of accounting. The statute and regulations require that the Commissioner must follow the method of accounting used by the tax-

payer in keeping his books if that method clearly reflects income. Consequently, since the accrual method of accounting is an approved method that clearly reflects income, the partnership has reported its true income.

II

The Courts below held that the entire contract price for dancing lessons was income at the time the contract was entered into rather than in the period when earned by the performance of services. This holding is in error as a matter of general law, as well as from an income tax and accounting standpoint. It disregards the basic precept of accrual accounting which holds that a clear reflection of income is obtained only by matching in a given period related revenue and expenses. The result is a complete distortion of the partnership's income because costs incurred to produce income are not properly matched against the income. The holding is wrong as a matter of general law since the partnership had no right to enforce payment of the full contract price under the executory contracts before rendering the service. It would only be entitled to recover damages arising from the breach of contract on the part of the student. This is generally measured by the loss of anticipated profits.

III

The Court below held that in the light of *American Automobile Association* case, the partnership's method of accounting did not for income tax purposes clearly reflect income. The Court below misinterpreted and misapplied *American Automobile* in view of the factual difference between the cases. In *American Automobile* the Court found it did not accurately reflect in-

come because the system was based on statistical computations and averages reflecting the over-all cost of rendering services to all its members on a group or pool basis. The Association was unable to establish the cost of rendering service to an individual member. The system used by the Association simply prorated the membership dues by the number of months and bore no relationship to the services to be rendered. In the case at bar the method of accounting for advance receipts accurately and precisely matched revenues in each tax year with related costs of rendering the services. This was easily accomplished because of the type of business and the card system employed. Despite the factual differences in the two accounting systems, the Court below rejected the partnership's accrual system on the authority of the *American Automobile* case. The *American Automobile* case only involved the taxation of advance cash receipts. It did not involve unreceived and unearned income. Yet the effect of the holding of the Court below is to tax as income the face amount of the contracts on which payment had not been received nor earned by performance of services. In addition, the decision of the Court below is in error in holding that income had accrued on the contracts on which payment had been received but not earned by performance of service. The decisions of this Court make it clear that in accrual accounting the time cash is actually received is not determinative of the time of its inclusion in gross income for purposes of taxation. *Brown* v. *Helvering* (1934), 291 U.S. 193, and *Spring City Foundry Co.* v. *Commissioner*, 292 U.S. 182. The basic precept of accrual accounting is the accurate matching of revenues with related cost. When this has been accomplished and true income determined, this Court's decision in *American Automobile* does not

prevent the deferral of advance receipts until the services have been performed and the income earned.

The legislative history of the enactment and repeal of sections 452 and 462 is not authority for disregarding the partnership's accrual accounting system. The Court in *American Automobile*, in giving consideration to the legislative history of these sections of the Code, specifically limited itself to the particular accrual accounting system employed by the American Automobile Association. The enactment and repeal of sections 452 and 462 is not authority for holding that the partnership's method of accounting, which accurately and precisely matches revenues with related expenses so as to reflect true income, can be disregarded.

ARGUMENT

I. THE ACCRUAL METHOD OF ACCOUNTING USED BY THE PARTNERSHIP CLEARLY REFLECTED ITS TRUE INCOME

The primary requirement of the tax law is that "Each taxpayer is required by law to make a return of his true income."[3] The rule has always been, as stated in *Eisner* v. *Macomber*, 252 U.S. 189, 206, that the income taxing statutes apply only to actual income computed "according to truth and substance without regard to form." In *Welp* v. *United States* (C.A. 8, 1953), 201 F. 2d 128, it was stated:

> "The objective of the Internal Revenue Code is the ascertainment and reporting of *true* income and the payment of the proper tax thereon. That objective should not be subordinated to formal methods or practices of bookkeeping or accounting * * *." (Italics supplied.)

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[3] Treas. Reg. 118, Sec. 39.41-3. (App. pp. 5a-6a)

The method of accounting employed by the partnership in the instant case in keeping its books clearly reflected its true income and fully complied with the applicable statutes and Regulations.

Since the Revenue Act of 1916, the accrual method of accounting has been recognized as an accounting system that "clearly reflected income." The legislative history of the Revenue Acts permitting the accrual system of accounting have been exhaustively set forth in many cases. In *United States v. Anderson* (1926), 269 U.S. 422, this Court first discussed the legislative development as follows:

> "A consideration of the difficulties involved in the preparation of an income account on a strict basis of receipts and disbursements for a a business of any complexity, which had been experienced in the application of the Acts of 1909 and 1913 and which made it necessary to authorize, by departmental regulation, a method of preparing returns not in terms provided for by those statutes, indicates with no uncertainty the purpose of §§ 12(a) and 13(d) of the Act of 1916. It was to enable taxpayers to keep their books and make their returns according to scientific accounting principles, by charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period; and indeed, to require the tax return to be made on that basis, if the taxpayer failed or was unable to make the return on a strict receipts and disbursements basis."

See: *Aluminum Castings Co. v. Routzahn* (1930), 282 U.S. 92; *Niles-Bement-Pond Co. v. United States* (1930), 281 U.S. 357; *Helvering v. Union Pacific Railroad Co.* (1934), 293 U.S. 282. See also opinion of Mr. Justice Stewart in *American Automobile Associa-*

tion v. *United States* (1961), 367 U.S. 687, at pages 711-744.

The present statutory basis authorizing accrual accounting for income tax purposes is sections 41 and 42 of the Internal Revenue Code of 1939, and sections 446 and 451 of the Internal Revenue Code of 1954. (App. pp. 2a-4a). Section 41 of the Internal Revenue Code of 1939 and corresponding sections of prior Revenue Acts require that:

> "The net income shall be computed upon the basis of the taxpayer's annual accounting period * * * in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but * * * if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. * * *"

Section 42 of the Internal Revenue Code of 1939 states the period in which items of gross income shall be recognized as follows:

> "The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *"

Section 41 requires that the method of accounting used by the taxapyer in keeping his books shall govern the computation of his net income. It is only when the method of accounting used by the taxpayer in keeping its books does not clearly reflect the income that the Commissioner has a discretion to compute his tax by another method.

Treasury Regulations 118, section 39.41-1 (App. pp. 4a-5a) in part provide:

> "* * * If the method of accounting regularly employed by him [taxpayer's] in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. * * *"

The statute and Regulations require that the Commission must follow the method of accounting used by the taxpayer in keeping his books if that method clearly reflects his true income.[4] Moreover, it is equally clear that the accrual method of accounting meets this requirement of the statute.

II. THE COURTS BELOW ERRED IN HOLDING THAT THE ENTIRE CONTRACT PRICE FOR DANCING LESSONS WAS INCOME AT THE TIME THE CONTRACT WAS ENTERED INTO RATHER THAN IN THE PERIOD WHEN EARNED BY THE PERFORMANCE OF SERVICES

The majority opinion of the Tax Court, which was affirmed by the Court of Appeals in its second opinion, held that "income" accrued to the partnership at the time the contracts were entered into, and said: (R. 258)

> "* * * When the contracts were entered into the amounts due thereunder were fixed and the students were 'liable to pay.' It is true that a payment of a portion of the contract price was deferred, but that does not affect the fixed and unconditional right of the Studio to receive the amount. Nor does the fact that the Studio was required to perform future services under the contract alter the Studio's right to receive since the deferred payments were in many cases due prior

[4] See *Huntington Securities Corporation v. Busey*, (C.A. 6, 1940) 112 F. 2d 368, and *John J. Harden v. Commissioner*, (C.A. 10, 1955) 223 F. 2d 418.

to the rendering of the services. And, the record shows that in most instances substantial payments were received prior to the performance of the services for which the payments were made."

This statement of the Tax Court is in error as a matter of general law, as well as from an income tax and accounting standpoint. The statement disregards the basic precept of the accrual system of accounting which holds that a clear reflection of income is obtained only by matching in so far as is reasonably practicable in a given period related revenue and expenses.[5] As noted before, this basic precept of accrual accounting was recognized by this Court in *United States v. Anderson* (1926), 269 U.S. 422, and *Helvering v. Union Pacific Railroad Co.* (1934), 293 U.S. 282, and other cases. The effect of compelling the partnership to include in income the entire contract price in the year the contract is signed is to grossly distort this taxpayer's true income.[6]

[5] Accountants' Handbook, Paton, 4th Ed. Wixon, Sec. 1, pp. 13-14. Finney & Oldberg, Lawyers Guide to Accounting, p. 49 (1955).

[6] The Commissioner's distortion of income is illustrated by the undisputed fact that although under the Commissioner's method gross income (evidenced by contracts signed during the year) increased from $430,293.65 in fiscal 1953 to $452,040.70 in fiscal 1954, or a 5% increase in sales (signed contracts), the net profit or taxable income for fiscal 1954 was actually decreased 55% despite a 5% increase in sales. Under the Commissioner's method net profits equalled 33.5% of gross income for fiscal 1953 as compared to only 14.4% for fiscal 1954. On the other hand, on the accrual basis used by the partnership, gross income increased 34.06% for fiscal 1954 over fiscal 1953, and the net profit was increased 32.3%. Under the partnership method, net profit equalled 15% of gross income in fiscal 1953 and 14.7% of gross income in fiscal 1954. (R. 213-215, Pet. Ex. 31.) This shows that the Commissioner's method results in a distortion of income because costs incurred to produce income are not properly matched against the income.

Furthermore, as stated above, the statement of the Tax Court that when the contracts were entered into the amounts due thereunder were fixed and the students were liable to pay, is wrong as a matter of general law. When a taxpayer, using the accrual method of accounting, enters into a contract to perform services in the future, and to receive payments in the future, all events which fix the right to receive income have not occurred and will not occur until the services are actually rendered. The question here is whether the taxpayer has a fixed right, upon entering into a contract, to receive as income the contract price. *Spring City Foundry Co. v. Commissioner* (1934), 292 U.S. 182.

As long ago as 1922, the Solicitor of Internal Revenue, in L. O. 1086, I-1 Cum. Bull. 87, 89, stated the rule as follows:

> "* * * in order to be accruable in the taxable year for which a return is made, a valid right to income must have arisen or existed in that year, *which is enforceable on the date the income is due.*" (Emphasis added)

The partnership had no right to enforce payment of the full contract price under the executory contracts before rendering the service. The partnership would only be entitled to recover damages (generally measured by the loss of anticipated profits) arising from the breach of contract on the part of the student. 5 Williston on Contracts, Sec. 1351, (Rev. Ed. 1937). In *United States* v. *Speed*, 8 Wall (75 U.S. 77), the government contracted with a butcher whereby he was to slaughter and pack hogs for the Army back in the Civil War days. The government cancelled the contract after it

was about one-third fulfilled. This Court held that the contractor was entitled to the agreed price, less the expense of fulfilling the remaining part of the contract.

In the case of *Levin* v. *Commissioner* (C.A. 3, 1955), 219 F. 2d 588, affirming 21 T.C. 996, a partnership, of which the taxpayers were members, executed a contract in December 1946 for advertising services which required services to be rendered from December 1946 to December 1947. In the taxable year 1946 the full amount of the contract price was accrued and claimed as an expense deduction by the taxpayers. The Court of Appeals, in affirming the Tax Court, held that the liability for payment of services to be rendered in the future did not accrue at the time the contract was executed and said:

> "It is well settled and taxpayers seem to agree that a liability does not accrue so long as it remains contingent. *Dixie Pine Products Co.* v. *Commissioner of Internal Revenue*, 1944, 320 U.S. 516, 64 S. Ct. 364, 88 L. Ed. 420; *Brown* v. *Helvering*, 1934, 291 U.S. 193, 54 S. Ct. 356, 78 L. Ed. 725; *United States* v. *Anderson*, 1926, 269 U.S. 422, 46 S. Ct. 131, 70 L. Ed. 347. They argue, however, that as the contract provided for cancellation only at the end of a year, liability became fixed for a year's services upon its execution. We do not think that provision determinative of the nature of the partnership's liability. The contract called for the display of cards by the transit company in the future. Rendition of the services was a condition precedent to any obligation of the partnership to pay. Where the contract, as here, contains mutually dependent promises, liability under it is contingent upon performance or tendered performance. Restatement, Contracts § 270 (1932) et seq.

Taxpayers also argue that the moment the contract was signed there was a fixed and determined liability for damages if they breached the contract in 1946. True, if they had breached the contract in 1946, some amount (though not necessarily \$8,796) might have become a fixed and determined liability, but the fact remains that there was no breach in 1946."

The law of Nebraska, Iowa and South Dakota follows the general rule that a party seeking to recover on an executory contract before performance is rendered is only entitled to recover damages for the breach which is measured by the loss of profits. *International Text-Book Co.* v. *Martin* (1908), 82 Neb. 403, 117 N.W. 994; *King Features Syndicate* v. *Courrier* (1950), 241 Iowa 870, 43 N.W. 2d 718; South Dakota Code, Sec. 37-1801 (1960 Supp.)[7] The foregoing authorities demonstrate that as a matter of general law the Tax Court was in error in holding that when the contracts were entered into the amounts due thereunder were fixed and the students were liable to pay.

III. THE AMERICAN AUTOMOBILE ASSOCIATION CASE IS NOT DISPOSITIVE OF THE ISSUE IN THE CASE AT BAR

The per curiam opinion of the Court of Appeals on remand (R. 273-274) held that in the light of *American Automobile Association*[8] case, the taxpayer's method of accrual accounting does not for income tax purposes clearly reflect income. The factual differences between the present case and the *American Auto-*

[7] South Dakota Code, Sec. 37-1801 (1960 Supp.):

"No person can recover a greater amount in damages for the breach of an obligation than he could have gained by the full performance thereof on both sides * * *."

[8] 367 U.S. 687 (1961).

mobile case makes it clear that the Court below misinterpreted this Court's decision in the *American Automoble* case. In *American Automobile*, this Court approved the exercise by the Commissioner of his discretion in rejecting the accrual accounting system employed by the taxpayer which deferred the reporting of income to subsequent years. The Court found that the accounting system used by the Association did not accurately and factually match revenues with related costs because it was based on statistical predictions and averages reflecting the over-all cost of rendering services to all its members on a group or pool basis. The Association was unable to establish the cost of rendering service to an individual member. There, the accrual accounting system simply prorated the membership dues by the number of months and bore no relationship to the services to be rendered.

In the case at bar, the method of accounting for advance receipts accurately and precisely matched revenues from services performed in each tax year with related costs of rendering the services. The dancing business operated by the partnership was the type of business that easily enabled it to record the revenue from each contract and the cost of performing under each contract. This was accomplished by use of the individual card for each student. On the card there was listed all pertinent information, including type of contract, hours of instruction involved, total contract price, history of lessons taught and payments made under the contract. (R. 252) The gross income from each contract was determined for each year by multiplying the hours taught by the hourly rate applicable to that contract. Costs were incurred in the period

that the partnership rendered services under the contract. (R. 193-195, 252.) The statistical approach employed by the *American Automobile* system cannot be compared with the accurate and precise card system used by the partnership here involved. Yet, the Court below, applying this Court's decision in the *American Automobile* case, rejected the taxpayer's accrual accounting system which accurately and precisely matched revenues derived from the performance of services in the same taxable year with the cost of rendering such service. The Courts below held that the entire contract price of the executory service contracts was income in the year in which the contracts were signed, even though the taxpayer could not receive nor earn the contract price except by performing services in a subsequent tax year. The *American Automobile* case only involved taxation of advance cash receipts. It did not involve unreceived and unearned income.

A. The Court below erred in holding income had accrued on the contracts on which payment had not been received nor earned by performance of services.

The Court below held that the entire contract price is income when the contract was signed even though the contracts were executory in that many payments were not due to be made until a subsequent taxable year.[9] No income had been earned under the contracts because the dancing lessons were not scheduled to be given until a subsequent year. This distinguishes the instant case from the *American Automobile* case which was dealing only with advance cash receipts paid to

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[9] See dissenting opinion of three Tax Court Judges. (R. 262-264).

the Association for which there may or may not have been future services required.[10]

The taxpayers in the instant case derived income from the teaching of ballroom dancing, not the signing of contracts. The signing of an executory contract, wherein a student promises to pay for lessons to be given in the future, does not meet the definition of when income accrues as stated in *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182, 184, as follows:

> "Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the *right* to receive and not the actual receipt that determines the inclusion of the amount in gross income. When the right to receive an amount becomes fixed, the right accrues. * * *"

While the contracts were executory, and until the dancing lessons were given, no income was *earned* and consequently, could not accrue. The "event" giving rise to income was the giving of the dancing lessons. Until the lessons were given there was no "right to receive" an amount which had become fixed within the meaning of the accrual accounting concept. Cf. *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182; *Brown v. Helvering* (1934), 291 U.S. 193. The Court below misapplied the *American Automobile* case in failing to distinguish between a taxpayer who had received advance cash receipts for which it might not be called upon to perform services and a taxpayer who had not

[10] Respondent recognized this in its Brief for the Respondent in Opposition, No. 793, Supreme Court, 1961 Term pp. 10-11, where it was stated, "Since the AAA case in fact involved only actual cash receipts, the Court cannot be said to have passed on this precise question in that case."

received advance receipts nor rendered any services. The difference between sales (as evidenced by contracts signed during the year) and cash received during the year equalled $48,200.13, $115,609.39 and $80,791.54 for 1952, 1953 and 1954, respectively.[11] In addition, the record in the instant case shows that there was no assurance whatever that payments would in fact be made on the contracts in future years. The Tax Court's opinion points out that cancellations were considerable in amount. A large number—over 20%—of the service contracts were cancelled during the years here involved. In addition, other contracts were required to be rewritten for a smaller number of lessons than had originally been contracted for in order to retain the student and not have the contract cancelled in its entirety. (R. 192, 239) In view of the foregoing, it is unrealistic to assume that the partnership would receive the unpaid portion of the contract at the time it was signed by the student. Until the services were rendered and the income earned, the partnership did not have a "fixed and unconditional right to receive the amount" due under the contract.

B. The Court below erred in holding income had accrued on the contracts on which payment had been received but not earned by performance of services.

The *American Automobile* case is not authority for holding that an accrual accounting system that accurately and precisely matches revenues derived from services performed in a tax year with related items of cost and expense may be rejected by the Commissioner

[11] The above amounts were arrived at by subtracting "Cash receipts" on Pet. Ex. 28, R, 209 from "Additions During Year—Contract Amount of Sales" on Pet. Ex. 24, R. 191.

as not clearly reflecting income. The decisions of this Court are uniform in pointing out that in accrual accounting the time when cash is actually received is not determinative of the time of its inclusion in gross income for purposes of taxation. In *Brown* v. *Helvering* (1934), 291 U.S. 193, 199, the Court stated:

> "If the accounts are kept on the accrual basis the income is to be accounted for in the year in which it is *realized* even if not then actually received; and the deductions are to be taken in the year in which the deductible items are incurred." [Italics supplied]

In *Spring City Foundry Co.* v. *Commissioner*, 292 U.S. 182, 185, the Court stated:

> "Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the right to receive *and not the actual receipt* (italics supplied) that determines the inclusion of the amount in gross income. When the *right* to receive an amount becomes fixed, the right accrues. When a merchandising concern makes sales, its inventory is reduced and a claim for the purchase price arises."

See also *Security Flour Mills Co.* v. *Commissioner* (1944), 321 U.S. 281, and *Commissioner* v. *Hansen*, 360 U.S. 446. See Mr. Justice Stewart's dissenting opinion in *American Automobile*, 367 U.S. pp. 711-715. The statement in *Brown* v. *Helvering*, *supra*, that "Income is to be accounted for in the year in which it is *realized*" (italics supplied) is the equivalent of saying that income is to be accounted for in the year in which it is *earned*.

In the *American Automobile* case the taxpayer failed to prove that the method of deferral used bore any

significant relation to the services to be performed in the future. In the instant case, the deferral bears direct relation to the services to be performed and which are in fact required to be performed under the terms of the contract. The partnership's obligation to provide services subsequent to the tax year was fixed, definite and certain and, furthermore, was identifiable as to untaught hours and unearned contract amount for each student contract outstanding at the end of the year.[12] The important factual distinctions are that in the case at bar (1) there was no pro rata allocation of income to periods on a time elapsed basis; (2) there was no pooling of expenses or a deduction of expenses on a pro rata basis; (3) there was no computation of profits based on average experience in rendering services or performance, and (4) there was no selling of availability of services. In the case at bar, (1) income is returned in the year of actual performance; (2) expenses are deducted when incurred; (3) profit is computed on the basis of actual events or transactions and the exchange of values, and (4) actual services are sold which can be identified for each contract as to the amount of performance rendered and the amount of performance yet to be rendered. Consequently, the case at bar falls within the rules of *Beacon Publishing Company* v. *Commissioner*, (C.A. 10, 1955) 218 F. 2d 697, and *Schuessler* v. *Commissioner*, (C.A. 5, 1956) 230 F. 2d 722, because the studio rendered actual dancing instructions to its students on fixed dates as scheduled, in accordance with the terms of the contracts.

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[12] The accurate matching of revenue with related cost in the instant case has been referred to by law journal writers as a "sophisticated system" when compared with the "rather crude accounting system" employed by the American Automobile Association, Journal of Taxation, August 1962, p. 104.

This is the principle on which this Court distinguished the *Automobile Club of Michigan* case and the *American Automobile Association* case from the *Beacon* and *Schuessler* cases.

In *Automobile Club of Michigan v. Commissioner* (1957), 353 U.S. 180, the *Beacon* and *Schuessler* cases were distinguished factually by pointing out that performance of the subscription in *Beacon* in most cases was in part, necessarily deferred until the publication dates after the tax year. In *Schuessler* it was pointed out that performance of the service agreement required the taxpayer to furnish services at specified times in years subsequent to the tax year. In the *Automobile Club* cases substantially all the services were performed only upon a member's demand and the taxpayer's performance was not related to fixed dates after the tax year. In the case at bar, the dancing students do not buy the availability of services. They buy the actual dancing instruction itself. In the *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180, the Court found that (p. 189) "The pro rata allocation of membership dues in monthly amounts is purely artificial and bears no relation to the services which petitioner may in fact be called upon to render for the member." This is not true in the case at bar. The Court of Appeals in its original opinion in this case pointed this out and said: (R. 289)

> "The facts before us are distinguishable. Here, petitioners' obligation to provide services subsequent to the tax year was fixed, definite and certain, thereby effectively rebutting any contention that petitioners' method of deferral was purely artificial. The system and method of accounting on an accrual basis with the deferral of income

so that it could be closely matched to the corresponding expenses, was designed to clearly reflect petitioners' true income within the meaning of the applicable statutes and regulations. As pointed out in the *Beacon* and *Schuessler* cases, any other method would result in a distortion of true income."

It is submitted that this Court's decision in the *American Automobile* case does not prevent the use of an accrual accounting system for tax purposes which accurately and precisely matches revenues derived from services performed in a tax year with the cost of performing such services.

C. The legislative history of the enactment and repeal of sections 452 and 462 of the Internal Revenue Code of 1954 is not authority to support the Commissioner's action in disregarding the taxpayer's accrual accounting system which accurately and precisely matches revenues and related cost.

The majority opinion in the *American Automobile* case gave consideration to the legislative history surrounding the enactment and repeal of sections 452 and 462 of the Internal Revenue Code of 1954 in finding that the Commissioner had properly exercised his discretion in disregarding the Association's accounting system. The Court held:

> "Finding only that, in light of existing provisions not specifically authorizing it, the exercise of the Commissioner's discretion in rejecting the Association's accounting system was not unsound, * * *."

Here the majority opinion specifically limited itself to the American Automobile Association's particular

accrual accounting system. The opinion of the Court had previously pointed out a number of reasons why the Association's accounting system did not reflect its true income. The enactment of sections 452 and 462 would clearly have justified the accrual accounting system used by the American Automobile Association. However, since those provisions were repealed, there was no specific provisions authorizing the sytem ased by the American Automobile Association. The enactment and repeal of sections 452 and 462 is certainly no authority for holding that a taxpayer's method of accounting, which accurately and precisely matches revenues with related expenses so as to reflect its true income, can be disregarded. The issue here is whether the accrual method of accounting used by the taxpayer clearly reflected its true income. This issue must be decided by interpreting sections 41 and 42 of the Internal Revenue Code of 1939 and sections 446 and 451 of the Internal Revenue Code of 1954.

The enactment and repeal of sections 452 and 462 did not alter or affect the basic requirement of the law that each taxpayer is required to report his true income. Nor do they change the necessary and inevitable conclusion that when a taxpayer has reported his true income he has complied with the law. Matters of form in the dress of bookkeeping or accounting practices should not be extolled over truth and substance.

CONCLUSION

The accrual method of accounting used by the partnership clearly reflected its true income. The hybrid system of accounting imposed by the Commissioner results in a complete distortion of income because of a failure to match revenues with related expenses.

Petitioners, therefore, pray that the judgment entered by the Court below should be reversed.

Respectfully submitted,

ROBERT ASH
CARL F. BAUERSFELD
1921 Eye Street, N. W.
Washington 6, D. C.
Attorneys for Petitioners

Of Counsel:

ASH, BAUERSFELD & BURTON

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